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INFO RHEFDIA/DIA WASHINGTON DC
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RUWSMXI/AMC INTEL CEN SCOTT AFB IL//INO/J2-J//
RUEPVAA/CDR JSOC FT BRAGG NC//J2/HSE//
RHMFISS/CDR USCENTCOM MACDILL AFB FL//CCJ2-JCH/HSE//
RHLFABN/CDR USESUCOM ABNCP VAIHINGEN GE//ECJ2/ECJ3/ECJ5-A//
RHMFISS/CDR USSOCOM MACDILL AFB FL//SOJ2/HSE//
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RHMFISS/CDRUSAREUR HEIDELBERG GE//AEAGB-IAD//
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RHEFNGB/NGIC INTEL OPS CHARLOTTESVILLE VA
RHEFNGB/NGIC INTEL OPS CHARLOTTESVILLE VA//IANG-CE-CM/IANG-GS-AA//
RHEFNGB/NGIC INTEL OPS CHARLOTTESVILLE VA//IANG/CE/CECM//
RUCXONI/ONI WASHINGTON DC//32/211//
RUEALGX/SAF WASHINGTON DC
RUEKJCS/SECDEF WASHINGTON DC//USDP-ISA-ADMIN//
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RUEPGAA/US SURVEY DIV SHAPE BE
RUMICEA/USCENTCOM INTEL CEN MACDILL AFB FL
RUEHIL/USDAO ISLAMABAD PK
RUCQSAB/USSOCOM INTEL MACDILL AFB FL
RUEHLO/AMEMBASSY LONDON 1300
RUEHNE/AMEMBASSY NEW DELHI 5471
RUEHBUL/AMEMBASSY KABUL 0872
RUEHLH/AMCONSUL LAHORE 7846
RUEHKP/AMCONSUL KARACHI 2242
RUEHPW/AMCONSUL PESHAWAR 6862
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REF: ISLAMABAD 1905

E.O. 12958: N/A
TAGS: ECON ETRD EFIN EAGR EINV ENRG PREL PK
SUBJ: BI-WEEKLY REPORT ON ECONOMIC ISSUES, 09 SEPTEMBER 2009

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TOP STORIES
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¶1. (SBU) The Ministry of Finance has neared agreement with commercial banks for the issuance of Rs. 85 billion in term finance certificates (TFCs) to flush out "circular" inter-corporate debt in the energy sector. The Ministry of Finance had originally sought Rs. 90 billion but some banks balked at taking on more energy and public sector debt. (Comment: The financial influx, which should happen by September 16, most likely will not be sufficient to completely flush the circular debt of the sector.)

¶2. (SBU) On Sept 1, the Business Recorder reported that President Asif Ali Zardari issued directives to launch the women-friendly 'Benazir Behan Basti Program' (BBBP). Under the proposed program, women holding Benazir Income Support Program cards would be given government land to construct houses. Financial support to construct the houses will reportedly be sought from Friends of Democratic Pakistan.

¶3. (SBU) Pak-Afghan border crossing at Chaman sealed. Pakistani Authorities sealed the border crossing at Chaman September 9 due to disputes over inspections of vehicles entering Pakistan. Afghan officials objected to the unloading of vehicles laden with fruit by Pakistani authorities, while Pakistani officials reportedly had reason to believe that weapons were being smuggled into the country from Afghanistan. The border closure resulted in the suspension of movement of supplies to NATO forces in Afghanistan. (Comment: Although the border reopened September 10, this is the second time in less than a month that a dispute involving the movement of commercial vehicles has effectively blocked ISAF cargo.)

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BANKING AND FINANCE
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¶4. (SBU) The International Monetary Fund (IMF) urges the government to raise revenues through a value added tax (VAT). The IMF mission chief has told the government that in order to lower its dependence on foreign aid, it has to either cut down on spending or raise revenue. A VAT will be able to raise the tax-to-GDP ratio by 3 to 4 percent, on top of the current ratio of 9 percent, one of the lowest in the world. (Comment: The GOP has sought U.S. technical assistance in designing and implementing the VAT, which it plans to introduce in FY11.)

¶5. (SBU) Banking spreads, or the difference between banks' cost of funds and their lending rates, dropped by 17 basis points to 7.35 percent in July 2009. According to data released by the State Bank of Pakistan, banking spreads have been decreasing continuously from a peak level reached in January 2009 of 7.78 percent. Financial analysts comment that with the easing of monetary policy, 2009 lending rates have also come down from a peak of 14.66 percent, to 13.79 percent in July; however, Pakistan's banking spread and interest rates are amongst the highest in the world. (Comment: The SBP has justified the high interest because of higher inflation. Large banking spreads in Pakistan reflect not only the interbank risk but also significant bank markups.)

¶6. (SBU) Banking sector's profitability dropped 31 percent in first half of FY09. Bank profitability fell due to higher provisions for Non Performing Loans (NPLs) and higher expenses. Provisions for NPLs swelled to Rs 36 billion, an 88 percent increase for the period under review, and administrative expenses increased cumulatively to Rs 74.4 billion, a 20 percent increase. (Comment: The domestic economic slowdown on top of the global financial crises has resulted in a higher number of non-performing loans, which are concentrated both in the textile sector and in SMEs.)

¶7. (SBU) On August 24, Dawn reported that Meezan Bank Limited and international NGO Islamic Relief have signed a memorandum of understanding under which the former would assist the NGO to further enhance its Islamic microfinance operations in Pakistan by capacity building, training and product development support. (Comment: Meezan Bank said they are in the early planning stage.)

¶8. (SBU) On August 23, Dawn and Business Day reported that the State Bank has announced 'Payment and Settlement' systems of home remittances under Pakistan Remittances Initiative (PRI). A circular has been issued by the SBP stating their objective for establishing automatic delivery of home remittances (transfers of money back home to relatives and friends), in real time with confirmation through mobile phone Short Message Service (SMS) to remitters and beneficiaries. Other objectives are to develop a robust and reliable ATM network to offer options to beneficiaries to withdraw cash during after banking hours and on holidays, and integrated and secured payment system infrastructures to make P2P payments, payments at merchant sites, payment of utility bills, fund transfers etc. (Comment: This is another step by the State Bank of Pakistan to increase the flow of remittances through the formal channel. The circular can be found at:
http://www.sbp.org.pk/press/2009/index2.asp During the first two months (July-August) of the 2009-10 fiscal year (FY10) an amount of

$1.525 billion was sent home by overseas Pakistanis, showing an impressive 25 percent rise when compared with $1.219 billion received in the same period last year.)

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STOCK MARKET
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¶9. (SBU) The Karachi Stock Exchange (KSE)-100 Index ended the week of September 4 at 9,002.67, up 5.4 percent from the previous week close. Overall market capitalization increased to $31.81 billion from 30.24 billion. Net portfolio investment inflow was $86.2 million - a more than threefold increase over the previous week. (Comment: Adnan Afridi, Managing Director of KSE, said breaking 9,000 was an important psychological barrier for investors. Since reaching that benchmark, applications for several new IPOs were announced. Afridi pointed out that the net foreign portfolio inflow was higher than India's for the week.)

¶10. (SBU) Foreign investors inject $95m into stock market. Gross buying by foreign portfolio investors (FPIs) was worth $142 million while selling stood at $47 million resulting in record net buying of $95 million in August 2009 which is the highest figure in any single month over the last 17. The release of pending installment of IMF loan and approval of additional funding built the confidence of offshore fund managers. Due to the foreign buying, the benchmark KSE-100 index moved up 12 percent in August. Foreigners share in total volume at the KSE remained at nine percent last month. (Comment: Pakistan's inclusion in the Frontiers Index and the release of the $1.2 billion IMF tranche bode well for Pakistan's stock exchanges. The relative undervaluation of Pakistani stocks compared to the regional markets also played a role.)

¶11. (SBU) The Lahore Stock Exchange (LSE) Index soared nearly 18 percent in two weeks. Analysts attributed the bull-run to foreign investment inflows sparked by a vote of confidence from the IMF, Standard & Poor's upgrading Pakistan to B-, and modest new oil discoveries. Market capitalization was up 10 percent and trading has been heavy throughout the rally.

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ENERGY, POWER AND WATER
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¶12. (SBU) Sindh government and Engro Power Gen Ltd signed an agreement for a joint venture on 60/40 basis to exploit Thar Coal for energy generation. Under the agreement, the first project of

the joint venture would be an open cast mining facility with an annual capacity of 3.5 to 6.5 million tones. Engro has been given the responsibility to carry out the feasibility study for a 600-1000MW Thar Coal-based power plant. (Comment: the World Bank has reportedly agreed to provide technical assistance amounting to Rs 2.4 billion ($30 million) to the government of Sindh and Private Power Infrastructure Board (PPIB) to exploit the Thar coal reserves for energy. However, it is not entirely clear that the issues surrounding provincial-federal jurisdiction over power plants of more than 50MW capacity have been fully resolved.)

¶13. (SBU) Pakistan State Oil (PSO) needs Rs. 158 billion by October 31 to avoid Letter of Credit (L/Cs) default. PSO has again warned the Ministry of Finance (MoF) that its letters of credit (L/Cs) for oil imports will default, this time if the ministry does not arrange the Rs 158 billion. According to a report in the Business Recorder, net outstanding receivables by PSO against the Water and Power Development Authority (Wapda), Hubco, Kapco and other customers stood at Rs 83 billion as of August 31, 2009. (Comment: The L/C problem just adds to PSO's woes. PSO is already in default to the oil refineries amounting to Rs 12 billion, and on its receivables side the power sector is its largest payee, having received furnace oil from PSO worth Rs 2 billion a day. Due to PSO's non-payments,

the refineries have reduced their production, which has, in turn, forced PSO to import refined oil at higher purchase prices. In a conversation with the Executive Director Finance Yaqoob Sattar at PSO, Sattar said that PSO has different payment terms with different refineries. On average they have a 3-week credit line with most refineries. After which the amount is said to be in default.)

¶14. (SBU) On August 25, Business Recorder reported that Gul Ahmed Energy Limited (GAEL), an independent power producer (IPP), stopped supply of 125 megawatts (MW) electricity to Karachi Electric Supply Company (KESC) due to non-payment of at least Rs 3.25 billion in debt. This is the second time within one month that GAEL has stopped supply to KESC for non-payment. Without payment from the utility, GAEL is unable to purchase fuel and pay operating expenses. (Comment: GAEL confirmed the report. Delayed, or non-payment to IPPs is an ongoing problem with KESC. Each month IPPs suspend production up to several hours at a time causing shortages and exacerbating the situation on an already under-supplied grid.)

¶15. (SBU) Indus and Jehlum daily river flows declined roughly 40 percent over the last two weeks, as mountain snowmelt and monsoons tapered off, according to Water and Power Development Authority (WAPDA) data. Water releases for irrigation and power have exceeded inflows, and both Tarbela and Mangla reservoir levels have started

to recede. (Comment: The GOP's failure to build more water storage capacity is already sparking conflict between irrigation demands for current rice, cotton, and sugar cane crops, and future water requirements for sowing wheat in November. Additional demand for hydroelectric power generation may tilt the balance toward current crops.)

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TRADE
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¶16. (SBU) On August 25, the Daily Times reported foreign shipping lines have increased terminal handling charges (THC) by around 30 to 35 percent, thereby negating the recent government reduction of port charges. The increase in charges is heavily affecting local traders, who termed the increase "unjustifiable" and condemned it. Traders claim they are already paying various "fictitious" on-port charges, including another THC being charged by the terminal operators. (Comment: That shipping lines are charging terminal handling fees at all speaks to the weakness of a system that should have clear lines of authority for charging these fees, a power fundamentally that rests with port authorities. Contacts at the port and Karachi Chamber of Commerce and Industry (KCCI) underlined the need to constitute a powerful watchdog from Customs to regulate the shipping lines, agents and freight forwarders.)

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AGRICULTURE
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¶17. (SBU) On September 4, the Daily Times reported that 30 to 40 percent of the onion crop was damaged during the recent monsoon rains in Sindh, and prices are expected to increase in the upcoming months. The most affected districts are Sanghar, Tando Allayar, Hyderabad and Mirpurkhas. Currently onion prices are stable in the wholesale and retail markets in Karachi because of substantial supply from Balochistan. The article added that the prices of onion are also stable in Punjab and NWFP, which are receiving bulk supply from Afghanistan. (Comment: While the Sindh Abadgar Board said that rains certainly affected the onion harvest, it refuted reports of a 30-40 percent loss. The Board, however, estimated a 10-12 percent loss.)

¶18. (SBU) Saudi Arabia is the latest Gulf State to express interest in leasing large tracts of Punjab farmland, according to press reports. The United Arab Emirates has been negotiating a possible deal since April, when the government of Pakistan first announced

that it would lease or sell millions of acres to foreigners in a bid to attract foreign direct investment and to import modern agriculture practices. A senior advisor to Punjab Chief Minister Shahbaz Sharif said the provincial government was cooperating with federal authorities on the program. Farmers' associations and some analysts have opposed the idea, asserting that it would harm small farm interests and jeopardize the country's already fragile food security. (Comment: Pakistanis are right to be cautious, but blanket objections are misplaced. The Gulf States intended to secure their own food supplies with these investments, not necessarily enhance Pakistan's connections to global markets. However, export-oriented, modern agri-business investment can be an excellent way to improve agriculture practices overall. Pakistan's crop yields are well below potential, so there is no inherent conflict between domestic food security and significant crop exports.)

¶19. (SBU) The federal and provincial governments launched a fruit processing center in Multan. The project was a joint effort between the Small and Medium Enterprise Development Authority (SMEDA) and the Punjab Small Industries Corporation (PSIC). The facility's suppliers are expected to be small growers in the area. The project has an independent board of directors and is supposed to operate as a self sustaining business. (Comment: Processing centers are badly needed to stem post harvest losses that claim as much as 30 to 40 percent of Pakistan's fruit crops. The plant's success will depend on whether it really functions as a competitive private enterprise, or if it becomes part of a government farm income support scheme.)

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SUGAR
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¶20. (SBU) The Lahore High Court (LHC) entered the so-called "sugar wars" September 3rd by ordering the Punjab government to maintain the retail price of sugar at PKR 40 per kilogram (kg), almost 20 percent below the set price of PKR 47 per kg. Millers, wholesalers, and retailers all balked at the decision, saying that they had acquired stocks based on previous prices and could not be forced to sell the sweetener at a loss. Not wanting to oppose the LHC ruling, some retailers pulled sugar from their shelves according to anecdotes from contacts and reports in the press, leading to shortages throughout the province. (Comment: The LHC's intervention is just another step on the government's spectacularly misguided path of price controls. The Pakistan Muslim League - Nawaz (PML-N)-led Punjab government scored political points in August when it objected to the Pakistan People's Party (PPP) central government's original sugar price, but the LHC has put the province

in an awkward position by lowering the price further still. Politically, the PML-N cannot appeal the LHC decision, but the provincial government lacks the distribution infrastructure, finances, and perhaps the desire to fulfill the court order. The PPP central government is not eager to bail the PML-N out of its dilemma.)

PATTERSON